



The Alpha-D Investment Philosophy

13 October 2008

INVESTAMENTAL PHILOSOPHIZING

"Most philosophies are like the sandwiches made for camera-ready advertising copy: impressive to behold but not particularly tasty or filling. Hey, now I'm hungry."

-Anthony J. Alfidi, Founder and CEO

The Alpha-D investment philosophy is a synthesis of several styles of thinking. It incorporates the low-cost index orientation of John Bogle; the focused deep-value and special situation competencies of Warren Buffett; and the private equity wildcatting of Silicon Valley. There is room for each of these disciplines in a multi-strategy portfolio, as articulated in David Swensen's "Yale Model."

Consistent application of the best practices and innovative thinking of the investment themes described here is the core of the Alpha-D approach. The S&P 500 Index, as a broad U.S. equity market index, is a somewhat useful benchmark of progress.

There is no real utility in assigning permanent weights to each strategy or its constituent asset classes, although this philosophy admits a more or less permanent tilt toward large-cap equities. Changes usually occur monthly, primarily to put new cash to work and refresh any short-duration option plays that expired the previous month. Selling out of long positions should be a rarity, because this incurs taxable events that degrade the portfolio's long-term performance. Sell criteria are limited to considering whether a focus strategy stock has a business model that is no longer viable, or whether any large-cap equity exposure is overvalued in the face of obviously deleterious macroeconomic conditions.

Check out each strategy in detail, if you're the curious type.

INDEX STRATEGY

"Diversification is important in choosing investments and girlfriends."

-Anthony J. Alfidi, Founder and CEO

An index strategy is the core of the Alpha-D approach. Indexing is a low-cost way to achieve diversification and reduce risk to that of a market portfolio, as John Bogle has argued for several decades. Warren Buffett has said that index investing offers protection from one's own ignorance. Some individuals can be good stock pickers, but even the CEO of Alfidi Capital probably isn't as good as Mr. Buffett. Partial reliance on an index strategy is indeed a form of protection against what no one can know.

Using ETFs for an indexing strategy instead of traditional index funds has the advantage of bringing buy-write ideas and other strategies into play. Using options on ETFs is a simple, low-cost way to add some yield to a strategy designed to match broad benchmarks.

ETFs serve the larger purpose of diversifying the Alpha-D portfolio by market capitalization and asset class. The ETFs are concentrated on the U.S. market because Alfidi Capital is a U.S.-based entity, and its earnings are denominated in U.S. dollars. Some ETF exposure to other developed economies and emerging markets is always welcome.

The intended holding period for long ETF positions is essentially forever, since a sale triggers tax consequences. The primary trigger for committing new money to an ETF position is mean reversion, i.e., buying more of an ETF that has declined since the last rebalance in the anticipation that its representative style will eventually rebound.

FOCUS STRATEGY

"I like value investing because I'm one cheap bastard."

-Anthony J. Alfidi, Founder and CEO

In addition to an index strategy, Alfidi Capital's founder pursues a strategy of focused investing in individual publicly-held companies. The firm publishes detailed research reports, free of charge, on each of these individual stocks. Our founder and CEO is our sole analyst and takes positions in these stocks in his own portfolio, just like any analytical team at a major firm ought to do if they believe in their own work (but most don't!).

Criteria for our founder's investments in select public equities are below. If some of them look familiar, it's because they are inspired by the ideas Warren Buffett has used to build Berkshire Hathaway into an investing powerhouse. Our founder is a deep value investor at heart, and is deeply indebted to Mr. Buffett for his wisdom.

An understandable industry. The firm's founder really only has the time or inclination to research a few industries: defense, logistics, natural resources, and renewable energy. Those are clearly defined circles of competence. Based on experience working with certain people in financial services (they know who they are), Alfidi Capital's founder is frankly skeptical of evaluating stocks of financial firms given the level of fraud and chicanery in that sector. This firm will only consider covering the stock of a financial services firm which deserves the custody of Alfidi Capital's own corporate assets or the personal assets of its owner.

A discount to intrinsic value. The buy trigger for a stock is a market value trading at a significant discount (25% or more) to our estimate of its true economic worth.

A durable competitive advantage. This is an insurmountable strength derived from a brand name, intellectual property, or a near-monopolistic competitive position.

Earnings consistency. At least five years of consistent earnings growth as measured by EPS, irrespective of dividend policy. No years of negative EPS growth at all.

Low long term debt. LT debt must be equal to or less than two times net income, but preferably less than net income. Low debt levels reduce a company's bankruptcy risk and reduce the sensitivity of its enterprise value to changes in interest rates.

High return on equity. At least 15% ROE (yoy). It's also nice to see ROIC in the same neighborhood (which is fairly easy if LT debt is low).

Low capital spending. Free cash flow per share must be positive.

Retained earnings that enhance shareholder value. The growth in EPS over ten years, when divided by retained earnings per share, should provide a return of at least 12% (yoy).

High-quality management. This is hard to assess, but it is a crucial consideration in managing firm risk. Top executives must be honest and competent. Alfid Capital's CEO looks favorably on companies run by founding or owning families, because they presumably have a strong interest in passing a healthy company to their heirs.

A deep option chain. A stock should have an option chain at least five strike prices deep in both its calls and puts, specifically in its shortest duration chain. Short-duration covered calls and other option ideas are an integral part of this focus strategy.

SPECIAL SITUATIONS STRATEGY

"I remember the first time I encountered a special situation. I had to be careful not to catch some disease."

-Anthony J. Alfidi, Founder and CEO

Alfidi Capital is fascinated by the potential to make outsized profits in the short term by investing in special situations. This type of event-driven investing is not for the squeamish, but a savvy investor can make a quick profit from events that temporarily lift or deflate a security's price. Short-duration options play a big role here. Here the firm borrows from Warren Buffett's "cigar butt" metaphor, but reserves the right to add its own flair.

Announced M&A activity. A friendly merger or acquisition is an excellent opportunity to arbitrage the prices of the two firms involved in the transaction. The key term here is "friendly," as a hostile acquisition dramatically increases the risk that this strategy will fail.

Index changes. When Standard and Poor's adds or deletes a stock from its S&P 500 index, this provides an excellent opportunity to identify a company whose price may be unnaturally high or low. This provides a unique window of opportunity for an investment.

National macroeconomic event. Country-specific ETFs provide investors with an incredible opportunity to profit from the effect that surprise news or larger economic events have on a national economy. These effects are typically short-lived, which is why country-specific ETFs (other than those of the U.S.) are not really meant for the core Index Strategy.

PRIVATE EQUITY STRATEGY

"Taking America private would cost me about a gazillion dollars. I'd better start saving up right now."

-Anthony J. Alfidi, Founder and CEO

The private equity portion of this portfolio consists of venture investments that Alfidi Capital's founder has made in startup companies. The companies identified here represent the portion of our founder's portfolio reserved for opportunities that entail high risk for high reward.

Here are the criteria for making a venture investment.

Disruptive technology. The startup must have some special "wow" tech that will revolutionize its industry. The IP can be something heretofore overlooked or so brand new that only a visionary can see where it fits. The firm's CEO is especially intrigued by any attempt to commercialize technology from research laboratories at Stanford University or U.C. Berkeley since they are in the founder's local area. There is no point in risking money on something that an established company can easily duplicate.

Serial entrepreneurs. At least half of the management team must have previous experience in leading at least one startup all the way from conception to liquidity event (an IPO, buyout, or merger with a publicly-held company). There is no point in risking money on rank amateurs with half-baked dreams.

Local to the Bay Area. Alfidi Capital is based in San Francisco, and its CEO does not have time to jet all over the world to poke around in someone's garage laboratory on a whim. Our CEO will only make venture investments in companies located within the nine-county San Francisco Bay Area.

An understandable industry. This means defense, logistics, natural resources, and renewable energy. A technology that intersects two or more of these sectors is especially worth our consideration.

Nota bene to entrepreneurs: Our CEO will only consider making private investments in companies that meet the criteria above, but he is willing to examine any and all business plans submitted. Who knows, we may be able to pass it on to another interested venture investor. If you decide to send in a business plan, include an executive summary and financial projections at a minimum. Please note that we will not sign a nondisclosure agreement (NDA) just to look at a plan.

Our CEO does not anticipate making more than one private equity commitment decision in a calendar year. Our CEO's investments up to the present have only been seed round, but he actively seeks opportunities for mezzanine investments (six months or less to liquidity). We are more than willing to entertain inquiries from venture funds or angel investors on potential partnerships.